

China's Financial Reform and its Impact on Hong Kong

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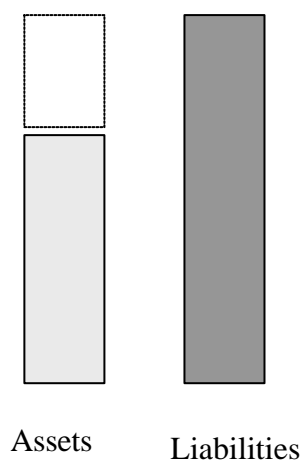
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- Sources of China's financial system risks.
- Why has not yet financial crisis happened in China?
- How to reduce China's financial system risks?
- Implications for Hong Kong.

The Problem of State Enterprises

- Privatization of profits and assets.
- Socialization of losses and liabilities.
- Asset-liability imbalance in the state sector troika of enterprises, banks, and budget.



China's GDP in 1996 is 6756 billion yuan
The unit for the number in the following tables is either billion yuan or % of GDP

Table 1. Balance sheet of China's state-owned enterprises, 1996					
Assets	11029	163%	Liabilities	6704	99%
			Owner's Equity	4325	64%
Table 2. Balance sheet of China's state banks, 1996					
Loans	6116	91%	Deposits	6860	102%
Other uses of fund	1787	26%	Other sources of fund	1043	15%
Table 3. Balance sheet of China's state budget, 1996					
Current revenues	741	11%	Current expenditures	794	12%
Domestic debt revenues	197	3%	Domestic debt payment	131	2%
			Outstanding domestic debt	427	6%
Net assets in SOEs	4325	64%	Implicit commitments in SOEs	2750	41%
			Net assets for budget	1161	17%

Table 4. Consolidated balance sheet of China's state enterprises, banks, & budget, 1996					
Assets in SOEs	11029	163%	Deposits	6860	102%
Other assets	169	3%	Outstanding domestic debt	427	6%
			Implicit commitments in SOEs	2750	41%
			Net assets for state budget	1161	17%
Total	11198	166%	Total	11198	166%
Implicit commitments in SOEs:					
24 m redundant workers, 25000 yuan each for termination costs				600	9%
100 m workers, 5000 yuan each for past pension contribution				500	7%
23 m retired workers, 10000 yuan each for past pension contribution				230	3%
Employee in-kind welfare including housing at 15% of fixed assets				620	9%
Known accumulated losses in SOEs at 7.7% of total assets				800	12%
Total				2750	41%

Table 5. Consolidated balance sheet of China's state enterprises, banks, & budget, 1996					
When estimated asset losses at 25% of total SOE liabilities			1676	25%	
Assets in SOEs	9353	138%	Deposits	6860	102%
Other assets	169	3%	Outstanding domestic debt	427	6%
			Implicit commitments in SOEs	2750	41%
			Net assets for state budget	-515	-8%
Total	9522	141%	Total	10037	149%

Table 6. Consolidated balance sheet of China's state enterprises, banks, & budget, 1996					
When estimated asset losses at 50% of total SOE liabilities			3352	50%	
Assets in SOEs	7677	114%	Deposits	6860	102%
Other assets	169	3%	Outstanding domestic debt	427	6%
			Implicit commitments in SOEs	2750	41%
			Net assets for state budget	-2191	-32%
Total	7846	116%	Total	10037	149%

Difficulty of dealing with the rising net state liabilities

- printing money ==> inflation.
- borrowing ==> rising national debts.
- selling SOE assets ==> not enough for liabilities.
- financial austerity ==> rising unemployment.
- selling nature resources ==> politically unacceptable.

The challenge is to reduce and eliminate net state liabilities

- Borrowing can meet current liabilities but would increase future liabilities with no change in net liabilities.
- Privatization can reduce both assets and liabilities but could not reduce the net liabilities.



Assets

Liabilities

Unlimited state liabilities and China's financial system risks

- Concentration of state power & state assets.
- Concentration of state liabilities and system risks.
- State ownership of capital brings negative "surplus value" when the state is not yet bankrupt.
- Rising net state liabilities as root of potential financial crisis.

Why has not yet financial crisis happened in China?

- The necessary condition for financial crisis: large net liabilities for private and/or state firms and banks (e.g. bad loans).
- The sufficient condition for financial crisis: the public loses confidence in the financial system (e.g. bank-run on deposits).
- China has met the necessary condition but not the sufficient condition.

China has maintained public confidence in its financial system

- China's central bank as inflation fighter.
- China's central bank as lender of last resort.
- RMB not convertible on capital account.
- Trade surplus \$40 bn in 1997.
- FDI between \$27 to \$41bn a year since 1993.
- China has accumulated \$140 bn reserves.
- Low external debt: \$116 bn, 14.3% of GDP.
- Low share of short-term external debt: \$14 bn.

The impact of China's full opening on world economy

- China is now at the verge of full opening and full integration into the world economy.
- One fifth of world's human resources are about to join with all the modern capital and technology the west could offer.
- Businessmen have to adjust their long-term strategy with a fully open Chinese economy.
- Financial markets are forward-looking, ahead of real adjustment, & overshooting.

Will China be able to avoid financial crisis in near future?

- China's backwardness implies future potential.
- low factor costs of labor, land (for manufacturing), and domestic capital (huge savings).
- high institutional costs for business transaction and organization.
- Reform of SOEs and state banks crucial for eliminating future financial crisis.

High costs of buying and selling ownership and control

- The judges in China are not yet able to enforce and fine-tune property rights and contracts based on efficiency.
- The ownership and control of SOEs and banks are fragmented when the state is their sole or majority owner.
- High quality but low cost financial services for buying and selling firms and banks are not yet available.

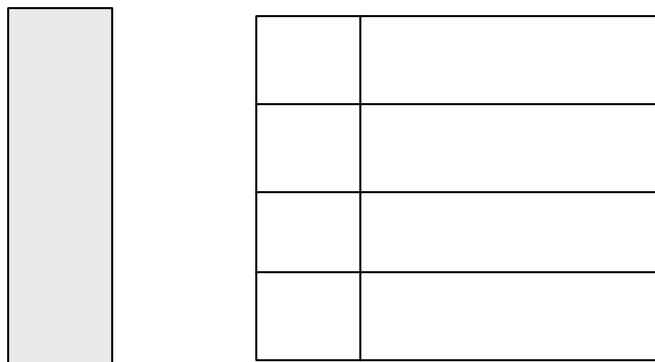
How to reduce institutional costs of doing business in China

- limit state's equity interest in any commercial business less than 30%.
- expand capital markets.
- make Hong Kong's high quality financial services available in Shanghai's Pudong.
- make US\$ or HK\$ an alternative money in China.

Diversification of state assets & liabilities in firms and banks

- To make ownership changes so that the state becomes passive minority shareholders.
- To establish real limited liabilities in firms and banks.
- To allow private owners to control enterprises and banks and make profits.
- To allow the state to share capital gain so as to balance the net liabilities once and for all.

An example of ownership reform making the state a non-majority shareholder



Rapid expansion of stock markets in China since 1991

- China's stock markets capitalization is only 10.9 billion yuan or 0.5% of GDP in 1991.
- But by the end of 1997, China's stock markets capitalization increased to 1753 billion yuan or 23.4% of GDP.
- China still has a long way to go in achieving a stock market capitalization of about 60%-70% of GDP as in U.S., Japan, Korea, and Taiwan.

High risks of state bank lending

- **Problem:** investment risks concentrated in the state banks due to lack of financing by equity, bond and private and foreign banks.
- **Solution:** expanding equity market, bond market, and private and foreign banks so that they can deal with lending risks better.
- **Benefit:** productive firms and government.
- **Cost & resistant:** corrupted government and banking officials.

How to rescue China's state banks? The mainstream approach

- Reducing the banks' tax burden.
- Lower capital reserve requirements.
- Government re-capitalization.
- Issuing equity.
- Entry of new domestic banks.
- Entry of foreign banks.

A quick and safe way to reform China's banking sector

- Separate lending and deposit-taking.
- Opening RMB lending business immediately to best foreign banks.
- Keep deposit-taking monopoly for the state banks for a while.
- Let foreign banks borrow short and long-term funds from the state banks in the inter-bank markets.

China's Interbank Market Opened to 8 Foreign Banks

By KARBY LEGGETT

Dow Jones Newswires, May 6, 1998

SHANGHAI, China -- China's decision to allow eight foreign banks to trade in its interbank and government-bond markets is a sign of its commitment to liberalize the country's financial markets. But it won't boost operations at foreign banks as long as crucial restrictions remain in place, bankers and analysts said.

China's rising foreign exchange reserves: The good news

- Reserves jumped from \$20 bn in 1993 to 140 bn in 1997 due to current account surplus, FDI, and the forced selling of all foreign exchange holdings by domestic enterprises since 1994.
- Reserves is now more than external debts and serves as a forceful backing for the stability of RMB.

The problems of high reserves

- One dollar increase in foreign exchange reserves would lead to about 8.3 yuan increase in China's domestic reserve money.
- The size of foreign exchange reserves increased from about 15% of China's currency in circulation (M0) in 1993 to 113% of M0 (33% of M1 & 13% of M2) in 1997.
- Have the domestic banking system been able to use the increased RMB money efficiently?

Should foreign banks share one third of China's banking business?

- One third of China's money supply is created by inflow of foreign money.
- China's state banks have monopolized the RMB deposits and are not good at making good loans.
- The scale of foreign capital inflows as well as foreign invested enterprises and projects would justify rapid expansion of foreign banks' USD & RMB business in China.

How to make RMB floating and convertible at low risks

- Fully convertible and floating RMB impossible in the near term due to time-consuming enterprise and banking reform.
- With US\$ or HK\$ as an alternative currency for legitimate business transactions (not for public circulation), the success of foreign trade and investment would not depend so heavily on RMB.
- China had successful experiences of using two currencies before 1994 and after 1997.

September 26, 1997

New Foreign-Exchange Rules Aim to Relieve Yuan Pressure

By KARBY LEGGETT and PETER WONACOTT
AP-Dow Jones News Service

SHANGHAI, China -- China's central bank unveiled new regulations giving exporters the right to keep their own foreign-currency earnings, in a move analysts say will relieve upward pressure on the domestic currency, the yuan.

Under the more relaxed exchange controls, which central bank Gov. Dai Xianglong revealed in an interview with the Chinese news media, exporters won't be forced to sell hard currency back to state banks. Instead, mainland companies can hold foreign exchange in their own bank accounts and convert it according to need. The rules go into effect Oct. 1, the China Securities Times reported Thursday.

What is Hong Kong's Comparative Advantage?

- Hong Kong's advantage is in low institutional costs for business transactions and organization.
- Hong Kong makes profits through large volumes of business transactions in trade, banking, securities, and other services.
- As a normal rule, Hong Kong's profits fluctuate with the volume of business transaction.

No panic necessary for Hong Kong's multiple equilibrium economy

- Why have the Hong Kong private business been able to afford such high rents and salaries before the Asian financial crisis?
- Why could not the Hong Kong private business afford even the falling rents and salaries during the crisis?
- Could the Hong Kong private business afford the still high rents and salaries compared to other places in the World?

Confidence would come when things happening are seen as normal

- Linked exchange rate is essential to reduce uncertainty brought about by fluctuations of large capital flows. What is the alternative?
- Housing prices are determined by supply and demand. Should we blame the fluctuating demand or the slowly changing supply?
- Fall in wealth ==> fall in consumption ==> fall in growth, all are normal but painful.

Hong Kong's future: serving China and the World

- Hong Kong still maintains and will continue to maintain low and competitive transactions cost. Hong Kong should aim at increasing the volume of transactions instead of lowering factor prices.
- With a physical and political border, Hong Kong's prices of land and labor would always be higher than those in Shanghai. Hong Kong should aim to raise the quality of land and labor by linking and integrating them with those in China.